

ST 05-12

Tax Type: Sales Tax

Issue: Manufacturing & Equipment Exemption – Manufacturing

**STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS**

**THE DEPARTMENT OF REVENUE
OF THE STATE OF ILLINOIS**

v.

**ABC INVESTMENTS, LLC.,
Taxpayer**

**No. 03-ST-0000
IBT No. 0000-0000**

NTL No. 00 00000000000000

**Kenneth Galvin
Administrative Law Judge**

RECOMMENDATION FOR DISPOSITION

Appearances: Mr. Daniel Austin, Richard S. Jalovec & Associates, Ltd. on behalf of ABC Investments, LLC; Mr. George Foster, Special Assistant Attorney General, on behalf of the Department of Revenue of the State of Illinois.

Synopsis:

This matter comes on for hearing pursuant to ABC Investment LLC's (hereinafter "ABC") protest of Notice of Tax Liability ("NTL") No. 00 00000000000000 issued by the Department of Revenue (hereinafter the "Department") on August 4, 2003, for use tax due on the purchase of equipment used in the baking of donuts. ABC's position is that the equipment is exempt from use tax under 35 ILCS 105/3-5(18) which exempts from use tax "manufacturing and assembling machinery and equipment used primarily in the process of manufacturing or assembling tangible personal property for wholesale or retail sale or lease." A hearing was held in this matter on February 10, 2005, with Mr. Witness and Ms. Witness Also testifying for ABC and Ms. Stavroula

Tsakanikas, Revenue Auditor 3, testifying for the Department. Following a careful review of the evidence and testimony, it is recommended that NTL No. 00 0000000000000 be finalized as issued. In support thereof, the following “Findings of Fact” and “Conclusions of Law” are made.

Findings of Fact:

1. The Department’s *prima facie* case, inclusive of all jurisdictional elements, is established by the admission into evidence of NTL No. 00 0000000000000, dated August 4, 2003, covering the audit period September, 1998, through June, 2001, issued to ABC and showing a use tax due of \$4,665.00 plus interest. Tr. pp. 13-14; Dept. Ex. Nos. 1 and 2.
2. The equipment at issue is a Model GA-16 doughnut retarder KCU-050 condensing unit, unit cooler and control processor used to keep donuts fresh after they are baked and a compass UL 2000 flour duster, transfer and cutting system. Tr. pp. 16-18, 56-58; Dept. Ex. No. 2.
3. ABC is a partnership consisting of “ABC Donuts” restaurants. Stavroula Tsakanikas performed a three-month test of receipts for each of ABC’s locations and traced daily cash register receipts from the three retail stores to bank deposits on the bank statements and to sales tax returns, finding no discrepancies. Register receipts were also reconciled to the federal income tax return. Tr. pp. 58-65; Dept. Ex. No. 2.

Conclusions of Law:

The Use Tax Act, 35 ILCS 105/1 *et seq.* (hereinafter referred to as the “UTA”) imposes a tax upon the privilege of using in this State tangible personal property purchased at retail from a retailer...” *Id.* at 105/3. The UTA was passed to complement and prevent evasion of the Retailers’ Occupation Tax Act. Needle Co. v. Department of Revenue, 45 Ill. 2d 484 (1970). On August 4,

2003, the Department issued a Notice of Tax Liability (“NTL”) assessing use tax upon ABC for the purchase of two pieces of machinery used in the preparation of donuts. Section 12 of the UTA (35 ILCS 105/12) incorporates by reference Section 4 of the Retailers’ Occupation Tax Act (35 ILCS 120/1 *et seq.*), which provides that the NTL issued by the Department is *prima facie* correct and is *prima facie* evidence of the correctness of the amount of tax due. *Id.* at 120/4. Once the Department has established its *prima facie* case by submitting the NTL into evidence, the burden shifts to the taxpayers to overcome the presumption of validity. Clark Oil & Refining v. Johnson, 154 Ill. App. 3d 773 (1st Dist. 1987).

A taxpayer cannot overcome the Department’s *prima facie* case merely by denying the accuracy of the Department’s assessments. Smith v. Department of Revenue, 143 Ill. App. 3d 607 (5th Dist. 1986). Testimony alone is not enough. Mel-Park Drugs, Inc. v. Department of Revenue, 218 Ill. App. 3d 203 (1st Dist. 1991). Documentary proof of tax-exempt status is required to prevail against an assessment of tax by the Department. Sprague v. Johnson, 195 Ill. App. 3d 798 (4th Dist. 1990).

In the instant case, ABC claims that the purchase of the machinery used in the preparation of donuts is exempt from use tax under 35 ILCS 105/3-5(18) which provides an exemption from use tax for “manufacturing and assembling machinery and equipment used primarily in the process of manufacturing or assembling tangible personal property for wholesale or retail sale or lease ...” This is commonly known as the manufacturing machinery and equipment exemption, hereinafter the “MM&E exemption.” This statute is an exemption statute, and as such, it is an exception to the general rule that property purchased for use in Illinois is taxable. Taxation is the rule; tax exemption is the exception. Rogers Park Post No. 108, American Legion v. Brenza, 8 Ill. 2d 286 (1956). Every presumption is against the intention of the state to exempt property from taxation and

the burden of sustaining the right to an exemption rests upon the party seeking it; the taxpayer must show clearly that specific property for which the exemption is claimed is within the contemplation of the statute. Reeser v. Koons, 34 Ill. 2d 29 (1966).

Regulations promulgated by the Department pursuant to the UTA clarify that 35 ILCS 105/3-5(18) exempts from use tax only machinery and equipment used primarily in the manufacturing or assembling of tangible personal property for sale or lease. “Thus, the use of machinery and equipment in any industrial, commercial or business activity which may be distinguished from manufacturing or assembling will not be an exempt use and such machinery and equipment will be subject to tax.” 86 Ill. Adm. Code § 130.330(b)(1). The section of the Regulations entitled “Manufacturing and Assembling,” states that “[T]he process or activity must be commonly regarded as manufacturing. To be so regarded, it must be thought of as manufacturing by the general public.” *Id.* at § 130.330(b)(3). The Regulations then state clearly that “[T]he preparation of food and beverages by restaurants, food service establishments, and other retailers is not manufacturing.” *Id.* at § 130.330(b)(7).

The MM&E exemption requires that the machinery at issue be used “primarily” in the process of manufacturing. 35 ILCS 105/3-5(18). Section d of the Regulations entitled “Primary Use” recognizes this provision of the statute and provides that “[T]he law requires that machinery and equipment be used primarily in manufacturing or assembling. Therefore, machinery which is used primarily in an exempt process and partially in a nonexempt manner would qualify for exemption. However the purchaser must be able to establish through adequate records that the machinery or equipment is used over 50 percent in an exempt manner in order to claim the deduction.” *Id.* at 130.330 (d)(1). The conclusion that must be drawn from 35 ILCS 105/3-5(18) and the Regulations is that in order to claim the exemption, the equipment at issue must be used

more than 50% in an “exempt process” such as manufacturing, and not in a nonexempt manner such as the preparation of food by a retailer for retail sale. 86 Ill. Adm. Code 130.330(d)(4)(I).

When the Department’s auditor audited the taxpayer, she concluded that ABC, a partnership consisting of “ABC Donuts” restaurants, was a food service establishment with its income derived “exclusively from the retail establishments.” The auditor concluded that the machinery at issue, used in the preparation of the donuts, did not qualify for the MM&E exemption because “ABC Donuts is a food service establishment and machinery or equipment used primarily in the preparation of food or beverages by restaurants for their dining customers does not qualify.” The auditor noted in her report that if ABC was baking donuts more than 50% for other business entities, they would be entitled to the exemption under the “primary use” exception for machinery used more than 50% in an exempt manner. However, “[I]f the taxpayer is baking donuts more than 50% of the time for its own bakeries, and the donuts are being distributed to the partnership’s retail stores, I think it’s safe to say the primary use of the equipment is taxable.” Dept. Ex. No. 2. The issue before this tribunal is whether ABC was baking donuts more than 50% of the time for other business entities and therefore entitled to the exemption because of the “primary use” of the equipment or whether ABC, a retailer, was baking donuts more than 50% for its own bakeries and therefore not entitled to an exemption for the machinery.

The auditor performed a three-month test of receipts for each ABC location, She traced daily cash register receipts from the three retail locations to bank deposits on the individual bank statements and to sales tax returns, finding no discrepancies. Register receipts were also reconciled to the federal income tax return. Tr. pp. 58-65. The auditor found only a “very small” amount of sales to entities other than ABC’s own retail customers. Tr. p. 60. The auditor was asked on direct examination:

- Q. Would it be fair to state that based on the review of the records that you looked at for ABC that you concluded that if they made sales to other entities other than the retail customers that it amounted to less than 50% of their total sales?
- A. What was on the register tapes was far less.
- Q. And what did you tie the register tapes into, if anything?
- A. To the bank statements, to the sales tax returns and then finally to the federal income tax return.
- Q. Did all those things agree?
- A. Yes.
- Tr. p. 65.

Because the auditor determined that ABC did not sell more than 50% of its donuts to other business entities, the machinery purchased was not exempt from use tax under the “primary use” exception for machinery used more than 50% in an exempt manner. According to the auditor, the majority of ABC’s sales were to its own retail customers and under the Department’s Regulations, the purchase of machinery or equipment used in the preparation of food and beverages by a retailer for retail sale, i.e. restaurants, vending machines, food service establishments, etc. is not entitled to the MM&E exemption. 86 Ill. Admin Code. 130.330 (d)(4)(I).

At the evidentiary hearing, ABC advanced several arguments as to why it was entitled to the exemption. Witness testified that he did not manage the day-to-day operations of ABC, but he was “involved with the franchisor when they told ABC Investments what the requirements were to purchase equipment.” Tr. p. 21. Mr. Witness testified that he would have to check ABC’s employment records to determine if he was an employee during the audit period. Tr. p. 22. He “believed” he had a percentage ownership of ABC of “approximately 5%” during the period in question. Tr. p. 27.

According to Mr. Witness, ABC manufactured doughnuts “for sale to other [ABC Donuts] franchises that don’t have a kitchen, and they would retail doughnuts and wholesale accounts which were lots of them, gas stations, high schools things like that.” Tr. pp. 18-19. ABC manufactured

doughnuts for “way more than two” different business entities in 1998. Mr. Witness would guess that “it could have been 30, 40 50” different business entities in 1998, 1999, and 2000. Tr. p. 19. Mr. Witness did not know if the other business entities that ABC manufactured donuts for had their own federal identification number. He didn’t see their federal ID number. “That’s not my job.” Tr. p. 20.

Mr. Witness was asked on cross-examination “how he was familiar with who ABC did or did not make sales to during the taxable period?” He responded: “I just saw the books and records as being familiar. I did not make the sales or book the sales or anything like that.” When asked what specific books and records he looked at, he responded that “it would have been the balance sheet or the income statement that would show outside sources of income.” He looked at the balance sheet “years ago” and that was the last time he looked at it. Tr. pp. 24-25. He could not recall “dollar amounts” but he could recall “line items that outside revenue was taken in by ABC Investments.” Tr. p. 25.

In order to overcome the presumption of validity attached to the NTL in the instant case, ABC had to produce competent evidence, identified with its books and records showing that the NTL is incorrect. Copilevitz v. Department of Revenue, 41 Ill. 2d 154 (1968). Testimony alone is not enough. Mel-Park Drugs, Inc. v. Department of Revenue, 218 Ill. App. 3d 203 (1st Dist. 1991). A taxpayer has the burden of proving by competent evidence that a proposed assessment is not correct. Young v. Hulman, 39 Ill. 2d 219 (1968). The Department’s Regulations, discussed above, state specifically that the purchaser of the equipment at issue must be able to establish through adequate records that the machinery or equipment is used over 50% in an exempt manner in order to claim that the machinery is exempt because of its “primary use.” 86 Ill. Adm. Code § 130.330(d)(1).

Mr. Witness's testimony regarding his familiarity with ABC's operations during the audit period was evasive. Mr. Witness, whose initials coincidentally are "ABC," couldn't remember if he was an employee of ABC but he "believed" he had a percentage ownership in it. Although he could not recall his position with ABC, he could recall what he saw on the balance sheet that he looked at "years ago." In spite of the Department's Regulations which require that the purchaser must be able to establish its right to the exemption through "adequate records," the balance sheet and income statement that Mr. Witness looked at were not offered or admitted into evidence. The "line items" that showed ABC's outside revenue were also not offered or admitted into evidence.

It must be noted that the NTL in this case was issued on August 4, 2003 and the initial status conference was held on October 15, 2003. ABC had more than a year before the evidentiary hearing of February 10, 2005 to collect "competent evidence, identified with its books and records," including the balance sheet, income statement and "line items," that Mr. Witness testified about. No documentary records were offered or admitted to back up any of Mr. Witness's testimony. Case law in Illinois is clear that testimony alone is not sufficient to overcome the Department's *prima facie* case. Mel-Parks Drugs, *supra*. Accordingly, I am unable to conclude, based on Mr. Witness's implausible testimony, that ABC sold more than 50% of its donuts to other business entities.

Witness Also testified that she was ABC's outside accountant and was familiar with their books and records during the audit period. Tr. p. 29. Ms. Witness Alsos' journal entries were admitted into evidence. App. Ex. No. 1. According to Ms. Witness Alsos, these journal entries allocated the costs of donuts and bagels manufactured by ABC for four other ABC Donut entities:

The bottom portion [of the work-papers] has account numbers for each of the other entities. That would be what they owed for the product that's going out.

Down below, [Account] 5010 would be food. [Account] 6000

was production payroll that I allocated, supplies, miscellaneous supplies and like paper products would be [Account] 5200. So that would be their portion of those expenses [that] were billed to those different corporations, and then I deducted the cost from [the] ABC side.
Tr. p. 33.

According to Ms. Witness Alsos, the product was sold to the four other ABC Donuts for them to resell. Tr. p. 34. Ms. Witness Alsos also completed a “synopsis” of her journal entries, entitled “Sales and Food Costs Analysis” Tr. pp. 37-38; App. Ex. No. 2. The synopsis depicts “the percentage of sales generated by the donut baking operations of ABC versus other entities.” The synopsis shows that in 1999, 67.5% of ABC’s sales were to “Others.” “Others” consists of only one FEIN and the business is unidentified. In 2000, 69.25% of ABC’s sales were to “Others.” Five unidentified FEIN’s and “Anywhere ABC Donuts” are listed under “Others,” but the sales are not broken down by location. For “2001 Jan-June,” 75.2% of ABC’s sales were to “Others.” The “Others” in this case are the “same as above.” App. Ex. No. 2. Although the audit period also included September through December, 1998, these records were in storage and Ms. Witness Alsos was not sure where. Tr. p. 42. Accordingly, the synopsis contains no information on 1998.

Ms. Witness Alsos testified further that the debit in her journal entries was to an intercompany receivable account on the balance sheet. Tr. pp. 45-46. When asked if she knew whether the receivables were ever collected from the other four entities, she responded that “[T]here was constant money coming in, yeah.” The money was collected in the form of a check and was deposited in ABC’s main checking account. Tr. pp. 47-48.

There are several problems with Ms. Witness Alsos’ testimony. No source documents for the journal entries were offered or admitted into evidence and I am unable to verify the dollar amounts of the entries and what documents were used to create them. Ms. Witness Alsos testified that she created the journal entries “a couple weeks” after each of the months at issue, but the

journal entries are not dated. Tr. p. 30. No chart of accounts was offered or admitted into evidence so I am unable to verify the names of the accounts included in the journal entries. The general ledger was not offered or admitted into evidence so I am unable to conclude that the journal entries were ever posted to ABC's general ledger. No financial statements were offered or admitted into evidence so I am unable to conclude that the accounts in the general ledger were ever incorporated into ABC's financial statements.

No information was presented on the four companies that, according to Ms. Witness Alsos, were billed through an intercompany account for donuts manufactured for them by ABC. No general ledger for ABC's intercompany account and no copies of bills sent to the four other companies by ABC were offered or admitted into evidence. No accounting books for the four other companies were offered or admitted into evidence so I am unable to verify how these four companies entered the intercompany bills on their own books. Because no information on these four companies was offered or admitted into evidence, I am unable to reach any conclusion as to the relationship of these four entities to ABC. I stated previously that the issue before this tribunal was whether ABC was baking donuts more than 50% of the time for other business entities and therefore entitled to the exemption because of the "primary use" of the equipment or whether ABC was baking donuts more than 50% for its own food service establishments and therefore not entitled to an exemption for the machinery. In order for me to conclude that ABC was baking donuts more than 50% of the time for other business entities, it was critical that evidence regarding the four companies and their relationship to ABC be admitted into evidence. Without this evidence, and recognizing that ABC had the burden of proving that it is entitled to the exemption, I must conclude that the four companies are affiliated with ABC and that if ABC was preparing donuts for

others, it was preparing donuts for retail sale by its own affiliated food service establishments and therefore not entitled to an exemption for the machinery.

According to Ms. Witness Alsos, Applicant's Exhibit No. 2, the "synopsis" of her journal entries, shows the percentage of sales generated by the donut baking operations of ABC. Since the source documents for the journal entries were never offered or admitted into evidence, the synopsis is fundamentally unreliable. In Mel-Park Drugs, Inc. v. The Department of Revenue, 218 Ill. App. 3d 203 (1st Dist. 1991), decided under The Retailers' Occupation Tax Act, the taxpayer offered into evidence "monthly totals of daily receipts and costs, but did not produce the source documents from which these totals were made..." *Id.* at 219. The court concluded that Mel-Park's summaries were not adequate, as a matter of law, to overcome the Department's *prima facie* case. *Id.* at 218-219.

Exhibit No. 2 does not include any information on the percentage of sales from ABC to other entities for September through December, 1998 which is included in the audit period, because these records could not be located. In 1999, Exhibit No. 2 shows that 67.5% of ABC's sales were to "Others." The "Others" include just one FEIN and the company is not identified. I am unable to conclude that this FEIN belongs to one of the four entities included in Ms Witness Alsos' journal entries because the FEIN's of these four entities were not offered or admitted into evidence. If this FEIN does belong to one of the entities in Ms. Witness Alsos' journals entries, I am unable to reach any conclusion as to how this entity was affiliated with ABC.

For the year 2000, Exhibit No. 2 shows that 69.25% of ABC's sales were to "Others." "Others" now includes five FEIN's, with these five FEIN's not identified and a sixth company, "Anywhere ABC Donuts," with no FEIN number. There is no breakout of individual sales to each of these six entities; only a total for all six is given. I am unable to conclude that any of the five

unidentified FEIN's for the year 2000 in Exhibit 2 belong to any of the four entities included in Ms. Witness Alsos' journal entries. If four of the FEIN's belong to the four entities in Ms. Witness Alsos' journals entries, I am unable to reach any conclusion as to how these four entities are affiliated with ABC. No explanation was offered as to why Anywhere ABC Donuts and at least one other FEIN in the year 2000 were not included in the intercompany billing procedure or Ms. Witness Alsos' journal entries. No explanation was offered as to the relationship of Anywhere ABC Donuts and this other FEIN to ABC.

For Jan-June, 2001, Exhibit 2 shows that 75.2% of ABC's sales were to "Others." "Others" are "Same as Above." There is no breakout of individual sales for the "Above" and only a total dollar amount is given. I am unsure if the "Above" means the one unidentified FEIN for 1999 or the five unidentified FEIN's and Anywhere ABC Donuts for 2000. Ms. Witness Alsos' testimony, her journal entries and the Exhibit 2 "synopsis" conflicts with Mr. Witness's testimony that ABC could have been manufacturing donuts for 30, 40 or 50 other business entities in 1998, 1999, and 2000. Tr. p. 19. No explanation was offered as to why Ms. Witness Alsos billed only 4 of the 30, 40 or 50 business entities that ABC was making donuts for and why so few of the 30, 40 or 50 business entities were included in Exhibit 2.

Ms. Witness Alsos testified that the debit in her journal entries was to an intercompany receivable account on the balance sheet. Tr. pp. 45-46. When asked if she knew whether the receivables were ever collected from the four entities, she responded that "[T]here was constant money coming in, yeah." The money was collected in the form of a check and was deposited in ABC's main checking account. Tr. pp. 47-48. On redirect examination, counsel for ABC asked Ms. Witness Alsos the following: "And you testified that the moneys [from other entities] did come in, and they were recorded in the journals and the deposits were made essentially, yes?" Ms.

Witness Alsos responded “[Y]es.” Tr. p. 48. Ms. Witness Alsos was then asked: “These receivable dollars that came in from the other entities for the costs that were reflected in [the journal entries], did these receivable dollars come in at cost?” She responded: “At what I billed out, which was cost.” Tr. p. 48.

Ms. Witness Alsos’ testimony that the donuts were billed to other entities “at cost” forces me to conclude that these entities are affiliated with ABC. ABC is a for-profit corporation and it is inconceivable that it would manufacture and sell donuts to competing, unaffiliated ABC Donuts entities at cost and earn no profit on the sale. The only logical explanation here is that ABC’s intercompany sales of donuts at cost are to ABC Donuts establishments that are affiliated with ABC and when the donuts are resold by the affiliated establishments, ABC shares in the profits.

Ms. Witness Alsos’ other testimony is not reconcilable with the auditor’s testimony. The auditor testified that she compared daily cash receipts to deposits made and traced deposits back to the register tapes for a three month period. Tr. pp. 72-73. The auditor looked “100% at every deposit.” Tr. p. 73. The auditor also testified that she asked ABC for “anything that would support their deduction.” Tr. p. 91. The auditor then testified that the records she was given by ABC were the records of Ms. Witness Alsos: “It was pretty much the books and records were the records of the accountant...” Tr. p. 95.

- Q. What do you mean by the records of the accountant?
- A. The supporting record, what she said was received in the bank, what was cash, what was total Line 1 to the sales tax return matched the books and records and then in essence the total of the year matched the federal income tax return.
- Q. And if money had been received from these other entities, would that have matched as you testified?
- A. No.
Tr. p. 95.

No bank statements showing ABC's receipts from the four entities billed for the cost of the donuts were offered or admitted at the evidentiary hearing. Ms. Witness Alsos testified that when money came in from these four entities, it was recorded in the journals and deposits were made. No journals showing this were offered or admitted into evidence. No evidence of the deposits were offered or admitted into evidence. An exemption claimant must clearly and convincingly prove entitlement to the exemption. United Air Lines, Inc. v. Johnson, 84 Ill. 2d 446 (1981). The documentary evidence, offered by ABC, consisting of the journal entries and the synopsis, do not establish that over 50% of ABC's sales were to other business entities and the evidence does not rise to the level of clear and convincing that is required to show that ABC is entitled to the exemption claimed.

As a statutory provision exempting property from taxation, the MM&E exemption, 35 ILCS 105/3-5(18) of the UTA, must be strictly construed against exemption. Chicago Patrolmen's Association v. Department of Revenue, 171 Ill. 2d 263 (1996). The burden of establishing the right to a tax exemption is on the one claiming the exemption. MacMurray College v. Wright, 38 Ill. 2d 272 (1967). In his opening statement, counsel for ABC stated "[T]his is a documentation dispute, plain and simple. The Department of Revenue wants this taxpayer to have incurred during the period in question large accounting and administrative documentation fees and costs that then, in turn, would have far exceeded the value of the qualified for tax exemption at issue today." Tr. p. 11.

The Department's Regulations define the parameters of the "burden" of establishing the right to the MM&E exemption for "primary use" of the equipment. The Regulations state that the purchaser of machinery must be able to establish through adequate records that the machinery or equipment is used over 50 percent in an exempt manner in order to claim the exemption. 86 Ill.

Adm. Code § 130.330(d)(1). This “burden” does not entail “large accounting and administrative documentation fees and costs.” The only records offered by ABC were journal entries and a synopsis of the journal entries. No source documents for the journal entries were offered. The synopsis and the journal entries, which are in conflict with portions of Mr. Witness’s testimony and with the auditor’s testimony, raised more questions than they answered. The journal entries and the synopsis were not adequate to show that the machinery at issue was used over 50% in an exempt manner and ABC has failed to establish, by these records, that it is entitled to the exemption claimed.

WHEREFORE, for the reasons stated above, I recommend that Notice of Tax Liability No. 00 0000000000000000 dated August 4, 2003, be finalized as issued.

Date: April 27, 2005

Kenneth J. Galvin
Administrative Law Judge